

Nord Stream expansion: what does it mean for Europe?

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Two announcements in sequence have shaken the energy debate on 18 and 19 June. Gazprom announced the signature of a Memorandum of Understanding with Shell, E.ON and OMV for the construction of strings 3 and 4 of Nord Stream, aiming at doubling the current 55 bcm capacity of the corridor running in the Baltic sea bed and connecting the Russian terminal of Vyborg to Germany. On the day after, a €2 bn deal between Russia and Greece was signed for extending the Turkish Stream project into Greek territory.

These moves are dictated by the Russian ambition of phasing out any gas transit to the EU through Ukraine by 2019.

Even if not entirely surprising – both extensions were planned – such a move is raising fundamental questions on the resilience of EU efforts to create a more integrated energy framework and speak with one voice on energy matters. Even if the Energy Union's communication did not advocate for the end of energy cooperation with Russia, its insistence on a reduction of the reliance on a single supplier and its efforts to diversify import routes and sources risk huge credibility problems. This is particularly relevant at a time when Russia, circumventing the Ukrainian route, would be able to expand its foreign policy options in Ukraine.

But is divide and rule still at the core of Gazprom's thinking? Probably it is still part of it – indeed, Russia would appreciate seeing the political unity over the EU sanctions vanish as a result of some preferential gas agreement. However, this has failed so far. Fears that Greece or Hungary could break the EU consensus as a result of gas discounts did not materialise, and on 22 June the EU foreign ministers agreed to extend the sanctions for six more months.

An alternative explanation for Russia's behaviour could have to do with the ambition of increasing capacity to enhance its market power in a moment when it is put at risk by the enforcement of EU competition rules. As in the aftermath of the EU's statement of objections against Gazprom, Russia will no longer be able to insert destination clauses in its contracts, so its ability to play prices by preventing its clients trading with each other will be diminished. As such, Russia will have to play with prices on the marketplace.

Combining an expanded Nord Stream and Turkish Stream, the total Russian export capacity to the EU will rise to about 360 bcm. Adding the current export (120 bcm) to the current spare production capacity (about 150 bcm), Russia would be able to pump much more gas to the EU than it does at the moment, while still being able to divert the gas currently flowing through Ukraine. Such a combination of spare production and export capacity means that in the future Russia could be able to price out not only any high-cost extraction producer in the Caspian, but potentially also US LNG, ensuring that fringe suppliers will remain marginal in the future.

This is likely to bring significant advantages to Russia. However, Russian plans have to confront a number of potential obstacles:

First, Gazprom is unlikely to obtain an exemption to Third Party Access requirements for the OPAL and NED pipelines – the onshore ramifications of Nord Stream in Germany. In the South, the Turkish Stream's necessary extensions are far from clear. These pipelines require, therefore, an adaptation of the EU internal grid outside Gazprom's control. Even if

this is consistent with the firm's new approach of selling gas at the borders, avoiding confronting EU rules on EU territory, it remains to be seen whether EU companies are going to commit to this investment.

Second, the financial challenges remain huge for Gazprom, and maybe insurmountable. The European expansion will add to efforts to build up the Power of Siberia and Altai pipeline, which aim at shipping Russian gas to China. All this in a framework where demand prospects are uncertain in both the European and Chinese markets. Considering the current European need for a flexible gas market design, EU clients will hardly accept being locked in rigid contractual schemes anymore, since in case demand collapses all of a sudden they will be the first casualties.

In such a situation, it will be fundamental to maintain a realistic point of view. The expansion of capacity will mean that Russia will be able to depress prices in Europe at any moment, reducing alternative suppliers' appetite for feeding the EU's demand. This means an increased dependence on Russian gas. Is this a blow to the Energy Union?

Not necessarily. If the EU removes its internal regulatory and physical barriers more assertively, Russia will be forced to keep prices low anyway, as it will constantly feel the pressure of competition in the different segments of the EU market, even if Gazprom wins the battle for market shares.

However, on the political side it must be acknowledged that the Nord Stream deal weakens Ukraine, exposing the contradictions of an approach that aims at reducing the reliance on Russian gas, increasing Eastern Europe's security of supply, and locking Russia into dependency on the Ukrainian route. Even if the deal will not necessarily jeopardise the EU's objective of moving towards a more integrated gas framework, increased bilateral cooperation can both encourage Russia to maintain an aggressive foreign policy and reduce the EU member states' mutual trust, which remains an essential precondition to move on with the Energy Union agenda. A discussion on priorities is very much needed.

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